SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1927

No. 156

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, PETITIONER

vs.

MILTON DAIRY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

INDEX

	Original	Print
Proceedings in U. S. C. C. A., Eighth Circuit	a	1
Caption [omitted in printing]	a	1
Record from D. C. U. S., District of Minnesota	1	1
Caption [omitted in printing]	1	1
Complaint	1	1
Exhibit A—Receipt for tax paid by Milton Dairy Co., to collector of internal revenue on aJnuary 31, 1923	7	5
Exhibit B—Application of Milton Dairy Co., for refund of tax for fiscal year ending February 28, 1919	7	6
Exhibit C—Receipt for tax paid by Milton Dairy Co., to to collector of internal revenue on January 31, 1923	7	8
Exhibit D—Application of Milton Dairy Co., for refund of tax for fiscal year ending February 28, 1920	9	9
Answer	11	12
Findings of fact and conclusions of law	11	12
Judgment	13	14
Opinion	13	14
Petition for writ of error and order allowing same	17	17
Assignment of errors	18	18
Bond on writ of error [omitted in printing]	19	19

	Original	Print
Record for D. C. U. S., District of Minnesota—Continued.		
Bill of exceptions	21	19
Caption	21	19
Arguments by counsel	22	19
Stipulation approving bill of exceptions	23	21
Order approving bill of exceptions, etc	24	21
Præcipe for transcript of record	25	22
Election as to printing record	25	22
Citation and service [omitted in printing]	26	22
Writ of error and return	27	23
Clerk's certificate [omitted in printing]	29	24
Appearances of counsel [omitted in printing]	30	24
Argument and submission [omitted in printing]	31	24
Opinion, Sanborn, J	32	25
Judgment	38	28
Clerk's certificate	39	28
Order allowing certiorari	40	29

a [Caption omitted.]

1 In United States District Court, District of Minnesota, Third Division

MILTON DAIRY COMPANY, PLAINTIFF

vs.

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, DEFENDANT

Complaint

Filed Jan. 14, 1925

The above named plaintiff for its complaint herein complains of the above defendant and alleges:

I

Plaintiff states that it is a corporation duly organized and existing under the laws of the State of Minnesota, having its principal place of business in the city of St. Paul, State of Minnesota, and that defendant now is and at all times herein mentioned was the duly appointed, qualified, and acting collector of internal revenue for the district of Minnesota.

II

Plaintiff for its first cause of action states that on or about the 3rd day of July, 1922, the Commissioner of Internal Revenue did
2 compute and assess additional income and excees profits taxes against this plaintiff for the fiscal year ending February 28th, 1919, in the sum of $4,141.57, and that of the amount so assessed the sum of $1,274.30 was erroneously and illegally assessed.

III

Plaintiff states that on or about the 25th day of January, 1923, the Commissioner of Internal Revenue and the collector of internal revenue did serve on this plaintiff a written notice and demand notifying this plaintiff that there had been assessed an additional income and profits tax for the fiscal year ending February 28th, 1919, amounting to $4,141.57, which additional tax included said sum of $1,274.30, erroneously and illegally assessed, and demanded of this plaintiff the payment of the same.

IV

That on or about the 31st day of January, 1923, in order to prevent penalties and interest, and pursuant to the aforesaid demand, said

plaintiff paid to said L. M. Willcutts, collector of internal revenue, the sum of $4,141.57, which included the sum of $1,274.30, erroneously and illegelly assessed. Copy of receipt of said collector for said payment is hereto attached marked Exhibit "A" and made a part hereof. Said payment was duly made under protest and duress.

V

That the commissioner in arriving at the amount of the tax for the fiscal year ending February 28th, 1919, omitted from the computation of invested capital the undivided profits of the preceding fiscal year, which profits remained in the business, amounting to $11,489.26, and such omission resulted in an illegal assessment of taxes amounting to $1,274.30.

VI

Plaintiff states that prior to the making of said assessment of additional tax the books and accounts of this plaintiff were examined, by an agent of the Commissioner of Internal Revenue, and that it appears from said examination that prior to the beginning of said fiscal year the capital of said corporation had been impaired by an operating deficit, and it further appeared from said examination that the profits remaining in said business for the preceding fiscal year, and which remained in the business for said fiscal year ending February 28th, 1919, amounted to $11,489.26, and it further appears from the report of said agent that in computing said
3 tax said agent and said Commissioner of Internal Revenue did exclude from the computation of invested capital the said sum of $11,489.26, and said failure to include said sum in the computation of invested capital of this plaintiff was erroneous and illegal, and by reason thereof the additional assessment made against this plaintiff as aforesaid was erroneous and illegel in the amount of $1,274.30.

VII

Plaintiff states that thereafter on or about the 9th day of February, 1923, it duly filed with the collector of internal revenue for presentation to the Commissioner of Internal Revenue an application for refund in manner and form as provided by the law and the regulations then in force, applicable to said case, copy of which is attached hereto marked Exhibit "B" and made a part hereof, and that said Commissioner of Internal Revenue on November 8th, 1923, wholly disallowed and rejected said claim for refund.

VIII

That by reason of the facts hereinbefore stated and alleged there is due and owing to this plaintiff from the defendant herein the sum of $1,274.30, with interest thereon from the 31st day of January, 1923.

IX

Plaintiff for its second cause of action states that on or about the 3rd day of July, 1922, the Commissioner of Internal Revenue did compute and assess additional income and excess-profits taxes against this plaintiff for the fiscal year ending February 28th, 1920, in the sum of $1,348.71, and that of the amount so assessed the sum of $529.89 was erroneously and illegally assessed.

X

Plaintiff states that on or about the 25th day of January, 1923, the Commissioner of Internal Revenue and the collector of internal revenue for the district of Minnesota did serve upon this plaintiff a written notice and demand notifying this plaintiff that there had been assessed an additional income and profits tax for the fiscal year ending February 8, 1920, amounting to $1,348.71, which additional tax included said sum of $529.89, erroneously and illegally assessed, and demanded of this plaintiff the payment of the same.

4

XI

That on or about the 31st day of January, 1923, in order to prevent penalties and interest, and pursuant to the aforesaid demand, said plaintiff paid to said L. M. Willcuts, collector of internal revenue, the sum of $1,348.71, which included the sum of $529.89, erroneously and illegally assessed. Copy of receipt of said collector for said payment is hereto attached marked Exhibit "C" and made a part hereof. Said payment was duly made under protest and duress.

XII

That the commissioner, in arriving at the amount of the tax for the fiscal year ending February 28th, 1920, omitted from the computation of invested capital the undivided profits of the two preceding years, which profits remained in the business, amounting to $29,853.03, and such omission resulted in an illegal assessment of taxes amounting to $529.89.

XIII

Plaintiff states that prior to the making of said assessment of additional tax the books and accounts of this plaintiff were examined by an agent of the Commissioner of Internal Revenue, and that it appears from said examination that prior to the beginning of said fiscal year the capital of said corporation had been impaired by an operating deficit, and it further appeared from said examination that the profits remaining in said business for the two preceding fiscal years, and which remained in the business at the beginning of said fiscal year beginning February 28th, 1920, amounted to $29,-

853.03, and it further appears from the report of said agent that in computing said tax said agent and said Commissioner of Internal Revenue did exclude from the computation of invested capital said sum of $29,853.03, and said failure to include said sum in the computation of invested capital of this plaintiff was erroneous and illegal, and by reason thereof the additional assessment made against this plaintiff as aforesaid was erroneous and illegal in the amount of $529.89.

XIV

Plaintiff states that thereafter on or about the 9th day of February, 1923, it duly filed with the collector of internal revenue for presentation to the Commissioner of Internal Revenue an application for refund in manner and form as provided by the law and the regulations then in force, applicable to said case, copy of
5–6 which is attached hereto marked Exhibit "D" and made a part hereof, and that said Commissioner of Internal Revenue on July 30th, 1924, wholly disallowed and rejected said claim for refund.

XV

That by reason of the facts hereinbefore stated and alleged there is due and owing to this plaintiff from the defendant herein the sum of $529.89, with interest thereon from January 31st, 1923.

Wherefore plaintiff asks that its claim against the defendant be determined in the amounts above set forth, and that judgment be entered against said defendant for the sum of $1,804.19, with interest thereon from the 31st day of January, 1923, and for its costs and disbursements herein.

IRA C. OEHLER,
Attorney for Plaintiff,
143 Endicott Bldg., St. Paul, Minnesota.

[*Duly sworn to by Albert S. Gowen; jurat omitted in printing.*]

Exhibit "A" to complaint

Treasury Department.
United States Internal Revenue.
Form 1107.

Taxpayer's Receipt for Income and Excess Profits Tax.

Office Collector Internal Revenue.
Form No. of return Dec. C-218-1922 list. Tax $4,141.57
Add'l 1919 income tax.

Notice to Taxpayer.

Before presenting payment to cashier enter on this form.

(*a*) Name.
(*b*) Address.
(*c*) Form number of return.
(*d*) Amount of tax paid.

Name Milton Dairy Co.,
177 So. Franklin St.,
St. Paul, Minn.

Received payment.
Received with remittance.
Collector of Internal Revenue.
District of Minnesota,
Jan. 31, 1923.
St. Paul main office.

Exhibit "B" to complaint

Treasury Department.
Internal Revenue Service.
Form 843—Jan., 1922.
Comptroller General U. S.
January 18, 1922.

Claim for

[ ]	Abatement of tax assessed.
[ ]	Credit against outstanding assessments.
[ ]	Refund of taxes illegally collected.
[ ]	Refund of amount paid for stamps used in error or excess.

Important
File with Collector of Internal Revenue where assessment was made. Not acceptable unless completely filled in.

Collector's notation
District
Account number
Date received
Stamp here
Collector of Internal Revenue

State of Minnesota, } ss.
County of Ramsey, }

Notice to Collector
Collector must indicate in block above the kind of claim, except in income tax cases.

Date received by Administrative Unit
Stamp here

Type or Print

Milton Dairy Company, ----------
(Name of taxpayer or purchaser of stamps)

(Residence—give street and number as well as city or town and State)

177 S. Franklin St., St. Paul, Minn. ----------
(Business address)

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

Period	Year
From: Fiscal year To: Ending Feb. 28	19.. 1919

1. Business in which engaged: Manufacture and sale of dairy products.
2. Character of assessment or tax: Income and profits tax.
   (State for or upon what the tax was assessed or the stamps affixed.)
3. Amount of assessment or stamps purchased $4,141.57
4. Reduction of tax liability requested (income and profits tax) ..... $.....
5. Amount to be abated ..... $.....
6. Amount to be refunded (or such greater amount as is legally refundable) $1,274.30
7. Dates of payment (see collector's receipts or indorsement of canceled checks). Jan. 31, 1923.
   (If statement covers income tax liability, items 8–11, inclusive, must be answered.)
8. District in which return (if any) was filed ..... Minnesota.
9. District in which unpaid assessment appears
10. Amount of overpayment claimed as credit ..... $.....
11. Unpaid assessment against which credit is asked; period from ..... to ..... $.....

Deponent verily believes that this application should be allowed for the following reasons:

That in arriving at the amount of the tax for the year ending February 2, 1919, there was omitted from the computation of invested capital, the undivided profits of the preceding fiscal year, which profit remained in the business, amounting to $11,469.26, and such omission resulted in an illegal assessment of tax amounting to $1,274.30.

That the Milton Dairy Company is advised that the regulations under which the respective amounts of undivided profits are excluded from the computation of invested capital of this taxpayer are not in accordance with the revenue law of 1917 and the revenue law of 1918, or either of said laws, and said regulations and each of them are, so far as they deny this taxpayer the right to include such undivided profits, illegal.

Exhibit "B" to complaint—Continued

It appears from the return of the agent that the impairment of capital is occasioned by an operating deficit which is true and no part of the capital of said corporation has been distributed to the stockholders in any manner.

(Attach additional sheets if necessary)

Sworn to and subscribed before me this 9th day of February, 1923.

(Information not now available)
(Title)

Signed:

MILTON DAIRY COMPANY,
By ---

(This affidavit may be sworn to before a deputy collector of internal revenue or revenue agent without charge.)

Exhibit "C" to complaint

9–10
Treasury Department.
United States Internal Revenue.
Form 1107.

Taxpayer's Receipt for Income and Excess Profits Tax.

Office Collector Internal Revenue.
Form No. of return Dec. C–219–1922 list. Tax $1,348.71
Add'l 1920 income tax

Notice to Taxpayer.

Before presenting payment to cashier enter on this form.
(a) Name.
(b) Address.
(c) Form number of return.
(d) Amount of tax paid.

Name Milton Dairy Co.,
177 So. Franklin St.,
St. Paul, Minn.

Received Payment.
Received with remittance.
Collector of Internal.
Revenue.
District of Minnesota.
Jan. 31, 1923.
St. Paul Main Office.

Exhibit "D" to complaint

Treasury Department
Internal Revenue Service
Form 843—Jan., 1922
Comptroller General U. S.
January 18, 1922

Claim for

- ☐ Abatement of tax assessed.
- ☐ Credit against outstanding assessments.
- ☐ Refund of taxes illegally collected.
- ☐ Refund of amount paid for stamps used in error or excess.

Collector's notation
District.
Account number.
Date received.
Stamp here
Collector of Internal Revenue

Important
File with Collector of Internal Revenue where assessment was made. Not acceptable unless completely filled in.

State of Minnesota } ss.
County of Ramsey }

Notice to Collector
Collector must indicate in block above the kind of claim, except in income tax cases.

Date received by Administrative Unit

Stamp here

Type or Print

Milton Dairy Company, ----------
(Name of taxpayer or purchaser of stamps)

(Residence—give street and number as well as city or town and State)

177 S. Franklin St., St. Paul, Minn. ----------
(Business address)

Exhibit "D" to complaint—Continued

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

Period	Year
From: Fiscal Year	19----
To: ending Feb. 28	1920

1. Business in which engaged: Manufacture and sale of dairy products.
2. Character of assessment or tax: Income and profits tax.
(State for or upon what the tax was assessed or the stamps affixed.)
3. Amount of assessment or stamps purchased $ 1,348.71
4. Reduction of tax liability requested (income and profits tax) $
5. Amount to be abated $ 529.89
6. Amount to be refunded (or such greater amount as is legally refundable)
7. Dates of payment (see collector's receipts or indorsements of canceled checks) Jan. 31, 1923
(If statement covers income tax liability, items 8–11, inclusive, must be answered.)
8. District in which return (if any) was filed Minnesota.
9. District in which unpaid assessment appears
10. Amount of overpayment claimed as credit $
11. Unpaid assessment against which credit is asked; period from to $

Deponent verily believes that this application should be allowed for the following reasons:

That in arriving at the amount of the tax for the year ending February 28, 1920, there was omitted from the computation to invested capital, the undivided profits of the two preceding fiscal years, which profit remained in the business, amounting of $29,853.03, and such omission resulted in an illegal assessment of tax amounting to $529.89.

That the Milton Dairy Company is advised that the regulations under which the respective amounts of undivided profits are excluded from the computation of invested capital of this taxpayer are not in accordance with the revenue law of 1917 and the revenue law of 1918, or either of said laws, and said regulations and each of them are, so far as they deny this taxpayer the right to include such undivided profits, illegal.

It appears from the return of the agent that the impairment of capital is occasioned by an operating deficit which is true and no part of the capital of said corporation has been distributed to the stockholders in any manner.

(Attach additional sheets if necessary)

Sworn to and subscribed before me this 9th day of February, 1923.

(Information not now available)
(Title)

Signed:

MILTON DAIRY COMPANY,

By ---

(This affidavit may be sworn to before a deputy collector of internal revenue or revenue agent without charge.)

11 [File endorsement omitted.]

In United States District Court

Answer

Filed May 13, 1925

The defendant L. M. Willcuts, collector of internal revenue for the district of Minnesota, answering the complaint herein denies each and every allegation thereof.

Wherefore, defendant asks that judgment be entered against the plaintiff and for his costs and disbursements herein.

LAFAYETTE FRENCH, Jr.,
United States Attorney for the District of Minnesota and Attorney for Defendant.

[*Duly sworn to by L. M. Willcuts; jurat omitted in printing.*]

[File endorsement omitted.]

In United States District Court

[Title omitted.]

Findings of fact and conclusions of law

This cause came on for hearing on the 22nd day of June, 1925,
12 the plaintiff appearing by its attorney Ira C. Oehler, and the defendant appearing by his attorneys Lafayette French, jr., United States attorney for the district of Minnesota, and T. Ellis Allison, special attorney, Bureau of Internal Revenue of the United States, and the said parties upon appearing by their respective attorneys as aforesaid, said cause was on stipulation by both parties tried to the court, and the court having heard and considered the evidence introduced and the arguments of counsel, and being fully advised now makes the following findings of fact and conclusion of law:

Findings of fact

That plaintiff is and was during all of the times material herein a corporation duly organized and existing under the laws of the State of Minnesota, having its principal place of business in the city of St. Paul in said State, and that defendant is and was during all of the times material herein the duly appointed, qualified, and acting collector of internal revenue of the United States for the district of Minnesota.

That upon an audit of plaintiff's income tax returns filed for the fiscal years ending February 28, 1919, and 1920, said audit being verified by plaintiff's books of account and records, the Commis-

sioner of Internal Revenue of the United States assessed on December 22, 1922, additional income and excess profits taxes against plaintiff for the said fiscal years in the sums of $4,141.57 and $1,348.71, respectively. That the said Commissioner of Internal Revenue and defendant herein did on January 25, 1923, serve on plaintiff written notice and demand of said assessment and for payment thereof. That on January 31, 1923, plaintiff paid defendant the amount thereof. That on February 16, 1923, plaintiff made and filed its application for refund of a portion of said additional taxes, to wit: $1,274.30 for the fiscal year ending February 28, 1919, and $529.89 for the fiscal year ending February 28, 1920, which said claim for refund of $1,274.30 was by the Commissioner of Internal Revenue rejected in full on November 8, 1923, and which said claim for refund of $529.89 was by said Commissioner of Internal Revenue on July 8, 1924, rejected in full.

That in plaintiff's returns for the fiscal years ending February 28, 1919, and 1920, its invested capital was increased for the fiscal year 1919 by the sum of $11,489.26, and for the fiscal year 1920 by the sum of $29,853.03, which amounts were claimed by the plaintiff to be undivided profits or earned surplus. That the said sum of $11,489.26 was the amount of plaintiff's net income for the fiscal year ending February 28, 1918. That $22,908.14 was the
13 amount of plaintiff's net income for the fiscal year ending February 28, 1919. That the sum of $29,853.03 was the amount of plaintiff's profits remaining in its business at the beginning of the fiscal year beginning February 28, 1920, and which had remained in said business for the two preceding fiscal years. That plaintiff's net income for the fiscal years 1918 and 1919 was not divided or distributed. That on February 28, 1917, plaintiff had an operating deficit, which depleted its capital, shown on its books of $70,296.12, and still had the same unprovided for during the fiscal years ending February 28, 1919 and 1920, when it claimed the said sums of $11,489.26 and $29,853.03 as undivided profits or earned surplus. That on February 28, 1917, plaintiff's invested capital was $145,817.04. That the Commissioner of Internal Revenue upon its audit of the returns of the taxpayer for the fiscal years 1919 and 1920 refused to accept the invested capital set up by plaintiff therein, but reduced the invested capital of the corporation as claimed by the plaintiff for the fiscal year 1919 by the sum of $11,489.26, and for the fiscal year 1920 as claimed by the plaintiff by the sum of $29,853.03. That said amounts were by the Commissioner of Internal Revenue applied against the operating deficit aforesaid.

Conclusions of law

(1) That the court has jurisdiction to the parties to the suit and of the subject matter thereof.

(2) That defendant is entitled to judgment against the plaintiff and for his costs and disbursements herein.

Wherefore, it is ordered that judgment be entered accordingly.

Dated July 30, 1925.

JOSEPH W. MOLYNEAUX,
Judge.

In United States District Court

Judgment

Filed July 31, 1925

Wherefore, in accordance with said order it is—

Considered, ordered, and adjudged that the plaintiff herein, Milton Dairy Company, take nothing by its said action and that said defendant, L. M. Willcuts, collector of internal revenue for the district of Minnesota, do have and recover of and from said plaintiff his costs herein to be taxed.

In United States District Court

Opinion

Filed July 31, 1925

The facts in this case may be stated as follows: In the com-
14 putation by the taxpayer of its income and excess profits tax for the fiscal year ended February 28, 1918, and the fiscal year ended February 28, 1920, it adopted an invested capital; that upon an audit of the return of the taxpayer the Government refused to accept the invested capital set up, but reduced the invested capital of the corporation for the fiscal year 1919, by the sum of $11,489.26, and for the fiscal year of 1920, by the sum of $29,853.03, which amounts were claimed by the taxpayer to be undivided profits or earned surplus; that on February 28, 1917, the company had an operating deficit shown on its books of approximately seventy thousand ($70,000.00) dollars, and when it claimed to have earned surplus it still had the same unprovided-for deficit which was greater than the total alleged earned surplus for the two years in question.

Reduction in invested capital operates to increase taxes. The increase was accordingly assessed and paid and the correctness of the assessment is now in dispute. The statute involved is revenue act of 1918 (40 Statutes at Large, pages 1058, 1092, and 1093):

"Sec. 326. (a) That as used in this title the term 'invested capital' for any year means (except as provided in subdivisions (b) and (c) of this section):

"(1) Actual cash bona fide paid in for stock or shares;

"(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifi-

cally issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: Provided, That the commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

"(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

"(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: Provided, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

"(b) As used in this title the term 'invested capital' does not include borrowed capital.

"(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

"(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

"The average invested capital for the prewar period shall be determined by dividing the number of years within that period during

the whole of which the corporation was in existence into the sum of the average invested capital for such years."

Plaintiff's contention is that under the provision—

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during year,"

16 the net profits for the two fiscal years above referred to should be added to the invested capital reducing the tax in the sum claimed in the complaint, $1804.19.

It is clearly provided by the statute that earned surplus or undivided profits constitute invested capital, but in my view the corporation did not have true earned surplus or undivided profits during the years in question. My view of this case is that the plaintiff's contention can not be sustained and that it violates the spirit and letter of section 326, rev. act of 1918 (40 Statutes at Large, pages 1058, 1092, and 1093).

The statute defines what assets shall go to make up "invested capital," at the time of the organization of the company or the inception of business, and an examination of the statute will show that such assets are to be taken at their real value in establishing the "invested capital," and as the corporation proceeds to conduct its business from year to year it may increase its capital stock by adding thereto the net surplus or profits. The question involved is, Did the taxpayer have any earned surplus or undivided profits for the fiscal year ended February 28, 1919, and the fiscal year ended February 28, 1920, which it could add to its "invested capital"? The statute provided the method of ascertaining invested capital at the organization of the corporation, specifically naming the items to be included and the items permitted would reflect the net assets of the corporation. The "invested capital" established by the corporation at its inception is not in controversy in this case. The controversy arose over the right of the taxpayer to increase the amount of the "invested capital" by the amount of the alleged earned "undivided profits" while it had upon its books the deficit referred to. The Government's claim is not that the earned surplus or undivided profits do not constitute "invested capital" but that the corporation had no true "earned surplus" or "undivided profits" during the years in question. At the time the corporation claimed to have "undivided profits" it had on its books a debit item denominated "operating deficit" which was in excess of the "undivided profits" for the two years in question.

This was a charge against the assets and reduced the assets in the amount of the debit. In computing its "surplus" or "undivided profits" it failed to take into account such debit. I think the scheme of the statutes is to ascertain the true value of the assets at the

17 inception of the corporation and to maintain the true value of the assets throughout the duration of the corporation, as the basis of calculating the amount of invested capital on which the tax is to be computed.

The corporation had a fixed invested capital at its inception, which represented the uninflated value of its assets. Only true earned surplus and undivided profits can be included in the computation of "invested capital" and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the accurate amount.

Holmes on Federal Taxation, 1919 ed., 728.

In order to do this in the present case it will be necessary to apply the earnings for the fiscal year 1919, $11,489.26, and the fiscal year 1920, in the sum of $29,853.03, against the $70,000 deficit upon the books.

JOSEPH W. MOLYNEAUX,
U. S. District Judge.

[File endorsement omitted.]

In United States District Court

Petition for writ of error and order allowing same

Filed Sept. 11, 1925

To the honorable District Court of the United States, District of Minnesota, Third Division, and to the Judges of said Court:

The plaintiff in the above entitled action feeling itself aggrieved by the judgment of said court in said cause entered therein on the 31st day of July, 1925, comes now by its attorney and petitions said court for an order allowing said plaintiff to prosecute a writ of error to the United States Circuit Court of Appeals for the Eight' Circuit, according to the laws of the United States in that behalf made and provided; and also that an order be made fixing the amount of security which plaintiff shall give upon said writ of error, and that upon the giving of said security all further proceedings in this court be suspended and stayed until the determination of said writ of error.

And your petitioner prays that a transcript of all of the proceedings in said cause together with the assignment of errors filed therein be duly authenticated and that the same be sent to the said Circuit Court of Appeals.

IRA C. OEHLER,
Attorney for Plaintiff.

18 Upon the motion of Ira C. Oehler, attorney for the plaintiff in the above-entitled cause, and upon the filing of the foregoing petition and the filing of the assignment of errors, it is by the court hereby ordered that a writ of error be, and hereby is allowed to have reviewed in the United States Circuit Court of Appeals for the

Eighth Circuit the said judgment heretofore entered herein; and that the amount of bond on said writ of error be, and hereby is fixed at $500.00.

Dated this 10th day of September, 1925.

JOSEPH W. MOLYNEAUX,
Judge.

[File endorsement omitted.]

In United States District Court

Assignment of errors

Filed Sept. 11, 1925

Comes now the Milton Dairy Company, plaintiff above named, and files the following assignment of errors upon which said plaintiff will rely in the Circuit Court of Appeals for the Eighth Circuit, for relief from the judgment rendered in said cause.

I

The court erred as a matter of law in holding that plaintiff's invested capital on February 28th, 1919, was $145,817.04.

II

The court erred as a matter of law in holding that plaintiff's invested capital on February 28th, 1920, was $145,817.04.

III

The court erred in failing to find that the sum of $11,489.26. net income of the plaintiff for the fiscal year ending February 28th, 1918, and left in the business, is an addition to the invested capital of the plaintiff for the years ending February 28th, 1919, and February 28th, 1920.

IV

The court erred in failing to find that the sum of $22,908.14, net income of the plaintiff for the fiscal year ending February 28th, 1919, and left in the business, is an addition to the invested capital of plaintiff for the year ending February 28th, 1920.

V

The court erred in determining that the earnings of the plaintiff for the fiscal year ending February 28th, 1919, and for the fiscal year ending February 28th, 1920, should be applied against the operating deficit on the books of the company, instead of making those earnings part of the invested capital of the plaintiff.

VI

The court erred in finding that defendant is entitled to judgment against the plaintiff.

VII

The court erred in ordering judgment against the plaintiff.

Wherefore said plaintiff prays that the judgment of the District Court of the United States for the District of Minnesota, Third Division, in the above-entitled action, be reversed, and that said court be directed to enter judgment in favor of the plaintiff Milton Dairy Company or grant a new trial of said cause.

IRA C. OEHLER,
Attorney for Plaintiff, Milton Dairy Company.

[File endorsement omitted.]

[Bond on writ of error for $500.00, approved and filed Sept. 11, 1925, omitted in printing.]

21 In United States District Court

Bill of Exceptions

Filed Oct. 15, 1925

CAPTION

The above entitled matter came on for hearing on June 22nd, 1925, at ten o'clock a. m., before Honorable Joseph W. Molyneaux, judge of said court, at the Federal Building, in St. Paul, Minnesota.

22 There were present and appearing Ira C. Oehler, Esq., on behalf of the plaintiff, and Lafayette French, jr., represented by T. Ellis Allison, Esq., on behalf of the defendant.

Thereupon the following proceedings were had:

ARGUMENT BY COUNSEL

Mr. OEHLER. The plaintiff and defendant in this case herewith stipulate that the plaintiff is a Minnesota corporation.

That the defendant now is and at all times mentioned in the complaint was the duly qualified and acting collector of internal revenue for the district of Minnesota.

That the Commissioner of Internal Revenue assessed an additional income and excess profits tax against the plaintiff for the fiscal year ending February 28th, 1919, in the amount of $4,141.57; that the defendant demanded payment of that sum of the plaintiff; that on January 31st, 1923, plaintiff paid said tax under protest; that claim

for refund was duly made, and filed with and disallowed by the Commissioner of Internal Revenue.

That the Commissioner of Internal Revenue assessed an additional income and excess profits tax against the plaintiff for the fiscal year ending February 28th, 1920, in the amount of $1,348.71; that the defendant demanded payment of said sum of the plaintiff; that on January 31st, 1923, plaintiff paid said tax, under protest; that claim for refund was duly made and [filled] with the Commissioner of Internal Revenue, and disallowed by commissioner.

This claim for refund and disallowance is only a condition precedent to the bringing of this suit.

That prior to the making of the two assessments the books and accounts of the plaintiff were examined by C. O. Mershon, an agent of the Commissioner of Internal Revenue; that a copy of his report, dated October 13th, 1921, furnished to the plaintiff by the Commissioner of Internal Revenue, may be received in evidence to show what the books of the plaintiff would show in connection with its income and profits tax liability for the years ending February 28th, 1914, to February 28, 1921, and that either party may refer to the facts stated in that report to the same extent that we would if the books themselves were in court.

23 That the invested capital of the plaintiff on February 28th, 1918, was $145,817.04.

That the books of the plaintiff on February 28th, 1917, show an operating deficit of $70,296.12.

That the net income of the plaintiff for the fiscal year ending February 28th, 1918, amounted to $11,489.26.

That the net income of the plaintiff for the fiscal year ending February 28th, 1919, amounted to $22,908.14.

That there was no distribution to stockholders of plaintiff in either of the fiscal years ending February 28th, 1918, February 28th, 1919, and February 28th, 1920.

That in computing the taxes due from plaintiff for the years ending February 28th, 1919, and February 28th, 1920, the Commissioner of Internal Revenue, each year, based the invested capital exemption on an invested capital of $145,817.04.

Mr. OEHLER. We now offer in evidence, Your Honor, the report of the examining agent, Mr. C. C. Marshon, referred to in stipulation.

The COURT. It will be received.

(Document marked "Plaintiff's Exhibit A.")

DEFENSE

(Argument to the court on behalf of the defendant by Mr. Allison.)

Mr. ALLISON. May I have a motion in the record for judgment, which I suppose you will deny.

The COURT. Yes.

STIPULATION APPROVING BILL OF EXCEPTIONS

It is stipulated by the above entitled parties through their attorneys that the foregoing transcript of the evidence and proceedings in said cause is correct, and the same may be certified by the Honorable Joseph W. Molyneaux, before whom said cause was tried, as a bill of exceptions containing a complete record and containing
24 all of the testimony and proceedings in said cause; said certificate may be made in the usual form according to the practice of this court.

ORA C. OEHLER,
Attorney for Plaintiff.
L. W. SCOTT,
Attorney for Defendant.

Dated this 9 day of October, 1925.

ORDER APPROVING BILL OF EXCEPTIONS AND AS TO ORIGINAL EXHIBIT

This cause having been brought on regularly before the court on this 9th day of October, A. D. 1925, upon the application of the plaintiff for the settling and certifying its proposed bill of exceptions, stipulated by defendant's attorney to be correct, and it having been stipulated that the same may be settled as the bill of exceptions in said cause;

It is ordered that the attached and foregoing be, and the same is hereby, settled as a true bill of exceptions in said cause, and I, the undersigned judge of the District Court of the United States, do hereby certify that the same contains all of the evidence received upon the trial of this action, the rulings of the court admitting or excluding the evidence and exceptions taken to said rulings, and all other proceedings in this action not otherwise of record herein.

It is further hereby certified that said bill of exceptions refers to the exhibit used in said cause, said exhibit being plaintiff's Exhibit "A," and that said exhibit was duly introduced in evidence upon the trial of said cause and marked as exhibit therein, and said original exhibit is not made a part of this bill of exceptions, it being stipulated by the parties hereto that same be not included, and it being deemed unnecessary by the undersigned judge of said court that said original exhibit be sent to the Circuit Court of Appeals.

JOSEPH W. MOLYNEAUX,
Judge, United States District Court.

Dated this 9th day of October, 1925.

[File endorsement omitted.]

25 In United States District Court

Præcipe for transcript of record

Filed Oct. 24, 1925

To the Clerk of said Court:

You will please prepare and forward to the clerk of the United States Circuit Court of Appeals for the Eighth Circuit at St. Louis, Missouri, as and for a transcript upon writ of error in the above entitled cause, copies of the following papers and records of said court in said cause:

1. Complaint.
2. Answer.
3. Bill of exceptions as settled by the judge of said court.
4. The judgment entered herein.
5. Petition and order for writ of error and fixing bond.
6. Writ of error.
7. Assignment of errors.
8. Bond and approval thereof.
9. Citation and admission of service.
10. This præcipe for record on writ of error.
11. Election as to printing of transcript of record.
12. Clerk's certificate.

Dated this 24th day of October, 1925.

HAYDEN S. COLE,
IRA C. OEHLER,
FREDERIC D. MCCARTHY,
Hayden S. Cole, Ira C. Oehler, and Frederic D. McCarthy,
Attorneys for Plaintiff, Milton Dairy Company.

[File endorsement omitted.]

In United States District Court

Election as to printing record

Filed Oct. 24, 1925

The undersigned, attorney for the plaintiff, Milton Dairy Company, in the above-entitled action, hereby files in the office of said clerk this notice of the election of said plaintiff to take and
26 file in the office of the clerk of the United States Circuit Court of Appeals for the Eighth Circuit, to be printed under the supervision of the clerk of said Circuit Court of Appeals under its rules, a transcript of the record on writ of error in said action.

IRA C. OEHLER,
Attorney for Plaintiff, Milton Dairy Company.

[File endorsement omitted.]

[Citation in usual form showing service on Lafayette French, jr., filed Sept. 14, 1925, omitted in printing.]

27 In United States District Court

[Title omitted.]

Writ of error and return

United States of America,—ss.
The President of the United States of America,
To the honorable the Judges of the District Court of the United States for the District of Minnesota, Third Division—Greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the said district court, before you, at the the June term, 1925, thereof, between Milton Dairy Company, a corporation, plaintiff, and L. M. Willcuts, collector of internal revenue for the district of Minnesota, defendant, manifest error hath happened, to the great damage of said plaintiff, as by its complaint appears,

We, being willing that error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then, under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the United States Circuit Court of Appeals for the Eighth Circuit, together with this writ, so that you have the said record and proceedings aforesaid at the city of St. Louis, Missouri, and filed in the office of the clerk of the United States Circuit Court of Appeals for the Eighth Circuit, on or before the 11th day of November,
28 1925, to the end that the record and proceedings aforesaid, being inspected, the United States Circuit Court of Appeals may cause further to be done therein to correct that error, what of right and according to the laws and customs of the United States should be done.

Witness, the Honorable William H. Taft, Chief Justice of the United States, this 11th day of September, A. D. 1925.

Issued at office in St. Paul, Minnesota, with the seal of District Court of the United States for the District of Minnesota, Third Division.

Seal
U. S. Dist. Court
Dist. of Minn.
Third Division

JOEL M. DICKEY,
Clerk of the District Court of the United States for the District of Minnesota.
By MARGARET L. MULLANE,
Chief Deputy.

Allowed this 10 day of September, A. D. 1925.

JOSEPH W. MOLYNEAUX,
United States Judge.

United States of America,
District of Minnesota,
Third Division—ss.

In obedience to the command of the above writ I herewith transmit to the Untied States Circuit Court of Appeals for the Eighth Circuit a duly certified transcript of the record and proceedings in the within entitled cause, with all things concerning the same.

In witness whereof I hereunto subscribe my name and affix the seal of the District Court of the United States for the District of Minnesota, Third Division.

Seal
U. S. Dist. Court
Dist. of Minn.
Third Division

JOEL M. DICKEY,
Clerk of the District Court of the United States for the District of Minnesota.
By MARGARET L. MULLANE,
Chief Deputy.

29 [Clerk's certificate to foregoing transcript omitted in printing.]

30 [Appearances of counsel omitted in printing.]

31 [Minute entry of argument and submission May 11, 1926, omitted in printing.]

32 In United States Circuit Court of Appeals, Eighth Circuit

No. 7235, September term, A. D. 1926

MILTON DAIRY COMPANY, PLAINTIFF IN ERROR vs. L. M. WILLCUTS, COLLECTOR OF INTERNAL revenue for the district of Minnesota, defendant in error	In error to the District Court of the United United States for the District of Minnesota

Mr. Ira C. Oehler (Mr. Haydn S. Cole and Mr. Frederic D. McCarthy were with him on the brief), for plaintiff in error.

Mr. John R. Wheeler, special attorney, Internal Revenue Bureau (Mr. Lafayette French, jr., U. S. attorney, Mr. L. W. Scott, assistant U. S. attorney, and Mr. A. W. Gregg, general counsel, Bureau of Internal Revenue, were with him on the brief), for defendant in error.

Opinion

Filed Sept. 25, 1926

Before SANBORN, Circuit Judge, and WOODROUGH and SCOTT, District Judges.

SANBORN, Circuit Judge, delivered the opinion of the court.

The plaintiff, the Milton Dairy Company, was liable to pay and paid income and excess profits taxes for the fiscal year ending February 28, 1919, and also for the fiscal year ending February 28, 1920, which it claimed were excessive to the amount of $1,804.19, and it seeks by this action to recover this amount from the defendant, the collector.

33 Pursuant to the established methods of ascertaining the amount of its income and excess profits taxes it made a return and statement of the income for each of these two years and deducted therefrom the "invested capital" of section 326 (a) of the revenue act of 1918, 40 Statutes at Large, p. 1058, 1092, 1093. The Congress by that act specified the items that might lawfully be thus deducted and declared them to be parts of the "invested capital" of that act. Therefore the increase of this "invested capital" necessarily decreased the taxable income and the tax and the decrease of this "invested capital" increased the taxable income and tax of the plaintiff for each of these years.

Section 326 (a), so far as relevant to the question in this case, provided:

"That as used in this title the term 'invested capital' for any year means * * *

"(1) Actual cash bona fide paid in for stock or shares.

"(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares * * *.

"(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year."

The plaintiff had a net income of $11,489.26 in the fiscal year ending February 28, 1918, which remained undivided and undistributed in use in its business during the years 1919 and 1920, and a net income of $22,908.14 in the fiscal year ending February 28, 1919, which remained undivided and undistributed in use in its business during the year 1920. In making its return and statement of its income and profits for the fiscal year 1919 it stated and claimed this $11,489.26 undivided profits as part of its "invested capital" of that year, and in making its return and statement of its income and profits of the year 1920 it stated and claimed this $22,908.14 undivided profits as part of its "invested capital" of that year. The Commissioner of Internal Revenue disallowed these claims and these disallowances resulted necessarily in an increase of the plaintiff's income and excess profits taxes for the fiscal years 1919 and 1920 by $1,804.19, which it paid under protest and brought this action to recover.

34 The only justification for these disallowances is the fact that in the fiscal year 1917 the plaintiff sustained a disastrous operating deficit in the conduct of its business which depleted its prior capital $70,296.12 and this declaration in Regulations 45, article 838: "There can, of course, be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses, or any other cause has been made good;" and the fact that Holmes on Federal Taxation, page 728 of the 1919 edition and page 1057 of the 1922 edition, prints the substance of this article 838 in the words thereof.

On the other hand, however, art. 860 of Regulations 45 revised declares that: "Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except where there has been directly or indirectly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital."

The argument in support of the commissioner's ruling and his decision in this case is that the allowance and the deduction of undivided profits of any fiscal year is conditioned by an excess of the value of the assets of the taxpayer over its liabilities at the end of that fiscal year and the practical effect of the imposition of such a condition is to exclude and except from the benefit of the deduction of "undivided profits" as part of the "invested capital" of section 326 (a) in the process of computing their taxable income and excess profits, all taxpayers of income and excess profits the value of whose assets through operating deficits or unfortunate losses in prior years have become less than their liabilities at the end of any subsequent fiscal year.

But the Congress by declaring undivided profits parts of invested capital by section 326 (a) seems to have granted this deduction to all payers of taxes on income and excess profits without excepting those whose assets did not exceed their liabilities and without the condition imposed by the ruling of the commissioner. There is certainly no expressed exception in the statute of taxpayers whose assets are less than their liabilities from the benefits of the grant and no expressed condition that the assets of the beneficiaries must equal or exceed their liabilities. As the Congress did not expressly make
35 any such exception or impose any such condition the legal presumption is that it did not intend so to do. There are other considerations persuasive of that conclusion.

By section 326 (a) (3) paid-in or earned surplus and undivided profits are made a part of the invested capital of that section and the invested capital of that section is not the same, has not the same meaning, and is not equivalent to the common, ordinary invested capital of commerce, but is unique and arbitrary and means only the items there specified as a part of that invested capital.

"The word surplus," says Mr. Justice Brandeis in Edwards v. Douglas, 46 Supreme Court Reporter 88, "is a term commonly employed in corporate finance and accounting to designate an account on corporate books. But this is not true of the words undivided profits. The surplus account represents the net assets of a corporation in excess of all liabilities, including its capital stock. This surplus may be paid in surplus, as where the stock is issued at a price above par; it may be earned surplus as where it was derived wholly from undistributed profits; or it may, among other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property * * *. By most corporations the term undivided profits is employed to describe profits which have neither been distributed as dividends nor carried to surplus account upon the closing of the books; that is, current undistributed earnings"; and that was the meaning upon which the decision in that case was based. And it seems certain that surplus in the sense of the excess of the value of assets over liabilities is not the same as the surplus or the undivided profits of section 326 (a) and does not necessarily condition the existence of either of them and that a taxpayer may have at the close of a fiscal year the undivided profits of section 326 (a), although it has no surplus of assets over liabilities and no earned surplus. In other words, it may have undivided profits of a fiscal year insufficient to constitute earned surplus, and it evidently was to grant the just deduction on account of such undivided profits that the Congress provided that earned surplus and undivided profits, not earned surplus or undivided profits, should constitute parts of the invested capital of that section.

It is well settled that the dominant purpose and practice of Congress in imposing taxes on income and excess profits was to
36 place the peculiar burden of these taxes on a graduated scale so that the heavier portion of the burden thereof should fall on those best able to bear them. The exception introduced by the commissioner of those payers of income taxes on excess profits who have been so unfortunate as to have suffered in earlier years depletion of their original business capital and have been unable to restore it, from the benefit of the deductions granted to them by Congress by section 326 (a) runs counter to that purpose and practice and tends to place the heavier burden of these taxes on those less able to bear them. If the Milton Dairy Company had not sustained its unfortunate operating deficit of 1917 and thereby the depletion of its business capital it would have enjoyed the benefit of the deductions granted to it by section 326 (a) (3) on account of its undivided profits of the fiscal years ending February 28, 1919, and February 28, 1920, and would not have been compelled or asked to pay the $1,804.19 here in controversy. Nor is this the worst of it. If this exception continues in force and in operation and the plaintiff remains unable to restore its original business capital it must continue to lose the benefit of this grant of deductions on account of its future undivided profits and to pay these excessive taxes on account of its

misfortune, and other payers of income taxes and excess profits in like situation whose capital has been depleted by unfortunate losses in earlier years and has not been restored must submit to like penalties for those misfortunes. We find no warrant for such an exception in the acts of Congress, nor are we persuaded that the Members of Congress ever intended to authorize or permit such an exception or practice.

Taxes on income and excess profits are annual taxes. The required return, statement, computation, and amount for each year are separate and distinct from those of every other year. The undivided profits of section 326 (a) (3) are the undivided profits of the single fiscal year for which the return is made, excepting the surplus and undivided profits earned during that year. The Congress provided that such undivided profits of each fiscal year should constitute parts of the invested capital of that section, and thereby granted proportionate reductions of the income of the taxpayer in the process of ascertaining its taxable income and excess profits, and in our opinion it was not and is not within the lawful jurisdiction or power of the
37 administrative officers or of the courts of the United States to make such an exception from or impose such a condition upon that grant. Lynch *v.* Alworth-Stephens Co., 267 U. S. 364. Let the judgment below be reversed and let the case be remanded to the court below with instructions to grant a new trial.

38 In United States Circuit Court of Appeals, Eighth Circuit

[Title omitted.]

Judgment

September 25, 1926

This cause came on to be heard on the transcript of the record from the District Court of the United States for the District of Minnesota and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the judgment of the said District Court, in this cause, be, and the same is hereby, reversed with costs; and that the Milton Dairy Company have and recover against L. M. Willcuts, collector of internal revenue for the district of Minnesota, the sum of one hundred nineteen and 45/100 dollars for its costs in this behalf expended and have execution therefor.

It is further ordered by this court that this cause be, and the same is hereby, remanded to the said District Court with instructions to grant a new trial.

39 In United States Circuit Court of Appeals, Eighth Circuit

Clerk's certificate

I, E. E. Koch, clerk of the United States Circuit Court of Appeals for the Eighth Circuit, do hereby certify that the foregoing contains

the transcript of the record from the District Court of the United States for the District of Minnesota as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its clerk, and full, true, and complete copies of all the pleadings, record entries, and proceedings, including the opinion, had and filed in the United States Circuit Court of Appeals, except the full captions, titles, and endorsements omitted in pursuance of the rules of the Supreme Court of the United States, in a certain cause in said Circuit Court of Appeals wherein Milton Dairy Company was plaintiff in error and L. M. Willcuts, collector of internal revenue for the district of Minnesota, was defendant in error. No. 7235, as full, true, and complete as the originals of the same remain on file and of record in my office.

I do further certify that on the twenty-sixth day of November, A. D. 1926, a mandate was issued out of said Circuit Court of Appeals in said cause, directed to the judges of the District Court of the United States for the District of Minnesota.

In testimony whereof I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit, at office in the city of St. Louis, Missouri, this second day of December, A. D. 1926.

[SEAL.]

E. E. KOCH,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.

40 In Supreme Court of the United States

Order allowing certiorari

Filed January 24, 1927

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

○

INDEX

	Page
Petition:	
Question presented	1
The statute	2
Treasury Regulations	4
Statement of the facts	6
Specification of error to be urged	7
Reason for granting the petition	7
Brief:	
Opinions below	9
Jurisdiction	9
Statement	9
Argument	9
Conclusion	14

AUTHORITIES CITED

Cases:	
Edwards v. *Douglas*, 269 U. S. 204	7, 11, 12
Gould Coupler Co. v. *Commissioner of Internal Revenue* (Board of Tax Appeals, decided Nov. 16, 1926; not yet reported)	13
Insurance Company of North America v. *McCoach*, 218 Fed. 905, affirmed 244 U. S. 585	11
LaBelle Iron Works v. *United States*, 256 U. S. 377	10, 11
Leather Manufacturers National Bank v. *Treat*, 116 Fed. 774	12
Long Beach Development Co. v. *Commissioner of Internal Revenue* (Board of Tax Appeals, decided Nov. 23, 1926; not yet reported)	13
Valdosta Grocery Co., Appeal of, 2 B. T. A. 727	14
Statutes:	
Revenue Act of 1918, c. 18, sec. 326, 40 Stat. 1057, 1092	2
Act of February 13, 1925, c. 229, 43 Stat. 936	9
Treasury Regulations No. 45 (1920 ed.):	
Art. 838	4, 11, 13
Art. 860	5, 11

In the Supreme Court of the United States

OCTOBER TERM, 1926

No. —

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, Petitioner

v.

MILTON DAIRY COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

The Solicitor General, on behalf of L. M. Willcuts, Collector of Internal Revenue for the District of Minnesota, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit entered in the above case on September 25, 1926, reversing the judgment of the United States District Court for the District of Minnesota.

QUESTION PRESENTED

In computing the invested capital of a corporation for the fiscal years 1919 and 1920, under Section 326 of the Revenue Act of 1918, can invested

capital be increased by the amount of net earnings for the fiscal years 1918 and 1919, where there existed at the beginning of the fiscal year 1918 an operating deficit of $70,296.12, and the net earnings for the years 1918 and 1919 were only $34,397.40, or should such net earnings first be applied to offset an existing operating deficit before there can be any surplus or undivided profits to be added to invested capital?

THE STATUTE

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1092:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section);
>
> (1) Actual cash bona fide paid in for stock or shares;
>
> (2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided,* That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and ad-

dress of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided,* That in no

case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

TREASURY REGULATIONS

Regulations 45 (1920 Edition), Article 838:

Surplus and undivided profits; earned surplus.—Only true earned surplus and undivided profits can be included in the compu-

tation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.

Regulations 45 (1920 Edition), Article 860:

Impairment of Capital.—Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except where there has been directly or in-

directly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital.

STATEMENT OF THE FACTS

The Milton Dairy Company, hereinafter referred to as the Company, is a Minnesota corporation, and L. M. Willcuts, petitioner, at all times hereinafter mentioned, was Collector of Internal Revenue for the District of Minnesota. The company kept its books on a basis of a fiscal year ending on the last day of February each year. The company filed a corporation income and profits-tax return for the fiscal year ending February 28, 1919, and included in its invested capital the sum of $11,489.26, alleged to be profits for the fiscal year 1918 remaining in the business and included in its invested capital for the fiscal year ending February 28, 1920, the additional sum of $22,908.14 alleged to be profits for the fiscal year 1919 remaining in the business. During the fiscal years 1918 and 1919 there had been no distribution of profits to the stockholders of the company. On February 28, 1917, at the beginning of the fiscal year 1918, the company had an impairment of capital resulting from an operating deficit of $70,296.12, which was in excess of the so-called profits for the fiscal years 1918 and 1919.

The Commissioner allowed as invested capital the sum of $145,817.04, which amount represented capital actually paid in prior to February 28, 1917.

The Commissioner excluded from invested capital the sums of $11,489.26 and $22,908.14, the operating profit for 1918 and 1919, on the ground that said sums must first be applied to make good the impairment of capital resulting from the operating deficit before there could be any surplus or undivided profits, to be treated as invested capital. Additional taxes were assessed and paid under protest for each of said fiscal years, and claims for refund in the sum of $1,274.30 for the fiscal year 1919, and $529.89 for the fiscal year 1920, were duly filed and rejected, whereupon this suit was instituted.

SPECIFICATION OF ERROR TO BE URGED

The court erred in holding that under Section 326 of the Revenue Act of 1918 the invested capital of a corporation can be increased by alleged earned surplus or undivided profits where there exists an operating deficit in excess thereof.

REASON FOR GRANTING THE PETITION

(1) The Circuit Court of Appeals has misconstrued Section 326 of the Revenue Act of 1918 in holding that invested capital can be increased by earnings where these earnings are insufficient to offset an existing operating deficit.

(2) The decision of the Circuit Court of Appeals is contrary to the decision of this Court in *Edwards* v. *Douglas,* 269 U. S. 204, in which it was held that surplus represents excess of assets over liabilities.

(3) A proper construction of Section 326 of the Revenue Act of 1918 is fundamental in auditing many thousands of corporation returns for excess-profits-tax purposes for the years 1917 to 1921, inclusive, and the opinion of the Circuit Court of Appeals overrules the settled practice and rulings of the Treasury Department since the passage of the first excess profits tax law, and affects a large number of cases not finally closed.

(4) This case is one of importance, both to the Government and to all corporations which filed excess-profits-tax returns, as the principle announced by the Circuit Court of Appeals changes the long-established and accepted practice of the Treasury Department and the basis generally adopted by the taxpayers in filing returns.

(5) The decision of the Circuit Court of Appeals is contrary to the uniform decisions of the United States Board of Tax Appeals, which results in the Board finding that additional taxes are due and must be paid, while the court rules that the same kind of tax must be refunded.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Eighth Circuit should be granted.

WILLIAM D. MITCHELL,
Solicitor General.

DECEMBER, 1926.

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The opinion of the District Court (R. 13) is reported in 8 F. (2d) 178. The opinion of the Circuit Court of Appeals (R. 31) has not been reported.

JURISDICTION

The judgment of the Circuit Court of Appeals to be reviewed was entered September 25, 1926. (R. 35.) Jurisdiction to issue the writ is found in the Act of February 13, 1925 (c. 229, 43 Stat. 936).

STATEMENT

A statement of the question presented and of the facts, and copies of the applicable statutes will be found in the petition.

ARGUMENT

UNDER SECTION 326 OF THE REVENUE ACT OF 1918 THERE CAN BE NO ADDITION TO INVESTED CAPITAL BY WAY OF SURPLUS OR UNDIVIDED PROFITS UNTIL NET EARNINGS HAVE EXCEEDED THE AMOUNT OF AN EXISTING OPERATING DEFICIT

In the case at bar it is agreed that the paid-in invested capital of the Company for the fiscal year 1918 was $145,817.04. (R. 13, 23.) The Company contends that it is entitled to add to this paid-in invested capital the full amount of earnings for the fiscal years 1918 and 1919, as profits remaining in the business, although those earnings were insufficient to offset an actual existing operating defi-

cit and impairment of capital as of the beginning of the fiscal year 1918. The Government contends that under Section 326 (a) (3) of the Revenue Act of 1918, until the earnings exceed a previous operating deficit there is no true earned surplus or undivided profits to increase invested capital.

Section 326 of the Revenue Act of 1918 is a statutory definition of what shall constitute "invested capital." The definition is both inclusive and exclusive. *LaBelle Iron Works* v. *United States,* 256 U. S. 377. It includes certain assets and excludes others. It excludes certain elements which in the ordinary sense are considered "capital." It is not synonymous with money used in the business for it excludes by the express words of the statute "borrowed capital" and "surplus and undivided profits earned during the current year."

It is submitted that the error of the Circuit Court of Appeals lies in the assumption that "invested capital" is synonymous with "money used in the business."

There is no true surplus and undivided profits within the meaning of Section 326 (a) (3) until earnings exceed the amount of an operating deficit.

Invested capital consists of—

(*a*) Cash *paid in* for stock or shares.
(*b*) Cash value of tangible property *paid in* for stock or shares.
(*c*) *Paid in* surplus.
(*d*) Earned surplus or undivided profits.
(*e*) A certain part of the value of intangible property *paid in* for stock or shares.

Thus the property which may be included in invested capital falls into one of two classes: (1) money and property *paid in,* or (2) earned surplus and undivided profits.

There is no question as to the invested capital of the company as of February 28, 1918. Its invested capital then was $145,817.04, that being the amount previously paid in and allowed by Article 860 of Regulations 45 (1920 Edition). That article has nothing to do with the controversy in this case. It refers only to " paid in " capital and holds that this can not be reduced. The regulation is based upon the decision of the Court in *LaBelle Iron Works* v. *United States,* 256 U. S. 377, and carries out the principle announced in that decision that " paid in " capital is a constant quantity not affected by either subsequent appreciation or depreciation in value. The sole question in the case at bar relates to an *addition* to invested capital of alleged earned surplus and undivided profits represented by the amounts earned in 1918 and 1919. Article 838 of Regulations 45 does not permit such addition because there can be no earned surplus and no undivided profits so long as there is an operating deficit.

In *Edwards* v. *Douglas,* 269 U. S. 204, this Court held (p. 214):

> The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock.

In *Insurance Company of North America* v. *McCoach,* 218 Fed. 905, 908, affirmed in *McCoach* v.

Insurance Company of North America, 244 U. S. 585, the Court said:

> The real surplus of a corporation is, of course, the difference between the aggregate value of all its assets and the sum of all its liabilities, including capital stock.

In *Leather Manufacturers National Bank* v. *Treat,* 116 Fed. 774, 775, 776, the court held:

> The only question presented is whether the word "surplus," * * * is to be construed as having some restricted meaning, or in its natural and ordinary sense, as including the entire overplus of assets over liabilities. * * * It would seem, rather, that Congress used the word "surplus" in its ordinary sense, as indicating the amount left over after setting aside sufficient of the assets of a banker to meet his liabilities.

The earnings in this case were not "in excess of all liabilities." There was no surplus, but an operating deficit.

There were no undivided profits, as that term signifies profits which may be but have not been divided among stockholders and which pass to "surplus" if not divided at the end of the year. The current profits in this case could not legally be divided. A distribution would further impair a capital account already impaired.

The definition of "undivided profits" approved by this Court in *Edwards* v. *Douglas,* 269 U. S. at page 214, footnote 4, is:

> Undivided profits.—Earnings or profits which have not been divided among the partners in a firm or the stockholders in a corporation.

There is, therefore, neither an earned surplus nor undivided profits, such as the statute contemplates may be added to paid-in capital for the purpose of increasing invested capital.

It is submitted that the company could not have a true earned surplus or undivided profits until the earnings exceeded the accumulated operating deficit. If the company in the case at bar had earnings prior to February 28, 1917, of approximately $34,000 and had thereafter sustained an operating deficit of $70,000 it would be absurd to state that the company had a surplus or undivided profits of $34,000. It is submitted that the conclusion can not be changed by a reversal of the controlling events.

Article 838 of Regulations 45 (1920 Edition) is a pronouncement of the fundamental economic principle that a surplus and a deficit can not exist at the same time. The regulation has been consistently followed by the Treasury Department and has been generally accepted as correct by taxpayers in filing excess-profits-tax returns.

The United States Board of Tax Appeals has approved it. See *Long Beach Development Co.* v. *Commissioner of Internal Revenue,* dated November 23, 1926 (not yet reported), *Gould Coupler Co.* v. *Commissioner of Internal Revenue,* dated No-

vember 16, 1926 (not yet reported), and *Appeal of Valdosta Grocery Company*, 2 B. T. A. 727.

CONCLUSION

It is apparent that because of an admitted operating loss which left its capital impaired, the respondent did not have a true earned surplus or undivided profits during the years in question and should not be allowed to increase its invested capital under the provisions of Section 326 (a) of the Revenue Act of 1918, and that the judgment of the District Court was right. Any artificial construction of the phrase "surplus or undivided profits" in Section 326 (a) which leads to the conclusion that a corporation whose capital is impaired by operating losses can have surplus or undivided profits available to increase its invested capital seems utterly untenable. While this statute has been repealed, many cases, not finally closed, are affected.

In view of the fact that the question here involved is of importance in the administration of the revenue laws, it is respectfully submitted that the petition for writ of certiorari should be granted.

WILLIAM D. MITCHELL,
Solicitor General.

A. W. GREGG,
General Counsel, Bureau of Internal Revenue.

J. R. WHEELER,
Special Attorney.

DECEMBER, 1926.

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INDEX

	Page
Opinions of the courts below	1
Jurisdiction	1
The question	2
The statutes	2
Treasury regulations	4
Statement	6
Specification of error to be urged	7
Summary of argument	7
Argument:	
Under Section 326 of the Revenue Act of 1918 there could be no addition to invested capital by way of surplus or undivided profits unless net earnings exceeded an impairment of capital resulting from previous operating deficits	8

CITATIONS

Cases:	
Edwards v. *Douglas*, 269 U. S. 204	13
Gould Coupler Co., Appeal of, 5 B. T. A. 499	12
Insurance Company of North America v. *McCoach*, 218 Fed. 905	10
LaBelle Iron Works v. *United States*, 256 U. S. 377	11
Leather Manufacturers' National Bank v. *Treat*, 116 Fed. 774	10
Valdosta Grocery Co., Appeal of, 2 B. T. A. 727	15
Statutes and Regulations:	
Revenue Act of 1918 (c. 18, Sec. 326, 40 Stat. 1057, 1092)	2
Treasury Regulations 45 (1920 ed.)—	
Art. 838	4
Art. 860	5

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In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 156

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, Petitioner

v.

MILTON DAIRY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF ON BEHALF OF THE PETITIONER

OPINIONS OF THE COURTS BELOW

The District Court rendered an opinion (R. 14) which is reported in 8 F (2d) 178. The opinion of the Circuit Court of Appeals (R. 25) is reported in 15 F. (2d) 814.

JURISDICTION

The judgment of the Circuit Court of Appeals was rendered on September 25, 1926. (R. 28.) Petition for certiorari was filed December 23, 1926, and granted January 24, 1927 (R. 29), pursuant to Section 240, Judicial Code, as amended by the Act of February 13, 1925.

THE QUESTION

In computing the invested capital of a corporation for the fiscal years 1919 and 1920, under Section 326 of the Revenue Act of 1918, should invested capital be increased by the amount of net earnings for the fiscal years 1918 and 1919, where there existed at the beginning of the fiscal year 1918 an operating deficit of $70,296.12, and the net earnings for the years 1918 and 1919 were only $34,397.40, or should such net earnings first be applied to offset an existing operating deficit before there can be any surplus or undivided profits to be added to invested capital?

THE STATUTES

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1092:

> SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section):
>
> (1) Actual cash bona fide paid in for stock or shares;
>
> (2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the Commissioner shall keep a record of

all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at

the beginning of the taxable year, whichever is lowest: *Provided*, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section 311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

TREASURY REGULATIONS

Regulations 45 (1920 Edition), Article 838:

Surplus and undivided profits; earned surplus.—Only true earned surplus and un-

divided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.

Regulations 45 (1920 Edition), Article 860:

Impairment of Capital.—Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, except

where there has been directly or indirectly a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital.

STATEMENT

The Milton Dairy Company, hereinafter referred to as the Company, is a Minnesota corporation, and L. M. Willcuts, petitioner, was Collector of Internal Revenue for the District of Minnesota. (R. 12.) The company kept its books on the basis of a fiscal year ending on the last day of February each year. (R. 13.) The company filed a corporation income and profits tax return for the fiscal year ending February 28, 1919, and included in its invested capital the sum of $11,489.26, alleged to be profits for the fiscal year 1918 remaining in the business, and included in its invested capital for the fiscal year ending February 28, 1920, the additional sum of $22,908.14 alleged to be profits for the fiscal year 1919 remaining in the business. (R. 13.) During the fiscal years 1918 and 1919 there had been no distribution of profits to the stockholders of the company. (R. 13.) On February 28, 1917, at the beginning of the fiscal year 1918, the company had an impairment of capital resulting from a previous operating deficit of $70,296.12 (R. 13), which was in excess of the so-called profits for the fiscal years 1918 and 1919.

The Commissioner allowed as invested capital the sum of $145,817.04 (R. 13), which amount

represented capital actually paid in prior to February 28, 1917. The Commissioner excluded from invested capital the sums of $11,489.26 and $22,908.14, the net earnings for 1918 and 1919, on the ground that said sums must first be applied to make good the impairment of capital resulting from the operating deficit before there could be any surplus or undivided profits to be treated as invested capital. Additional taxes were assessed and paid under protest for each of said fiscal years, and claims for refund in the sum of $1,274.30 for the fiscal year 1919, and $529.89 for the fiscal year 1920, were duly filed and rejected, whereupon this suit was instituted. (R. 13.) The District Court rendered a judgment for the Collector, which the Circuit Court of Appeals reversed.

SPECIFICATION OF ERROR TO BE URGED

The court erred in holding that under Section 326 of the Revenue Act of 1918 there is "surplus or undivided profits" which should increase the invested capital of a corporation where its past operations show an actual operating deficit, resulting in an impairment of its capital.

SUMMARY OF ARGUMENT

The words "surplus and undivided profits" used in the statute should be given their ordinary meaning. A corporation has no surplus or undivided profits unless its assets exceed its liabilities (including capital-stock liability).

If such an excess exists, it is often separated into two items on the books, one called "surplus" and the other "undivided profits," but neither can exist without such an excess of assets.

There is nothing in the language or the purpose of this statute to justify taking the words "surplus and undivided profits" in any other than their usual sense.

The fact that under this statute and the regulations that part of the statutory invested capital contributed by the stockholders was not to be reduced by operating losses does not require that net earnings in any year should be added to invested capital, although insufficient to restore impairment of capital resulting from previous operating losses.

The construction of the law uniformly followed by the Treasury Department over a long period of years should not be rejected.

ARGUMENT

UNDER SECTION 326 OF THE REVENUE ACT OF 1918 THERE COULD BE NO ADDITION TO INVESTED CAPITAL BY WAY OF SURPLUS OR UNDIVIDED PROFITS UNLESS NET EARNINGS EXCEEDED AN IMPAIRMENT OF CAPITAL RESULTING FROM PREVIOUS OPERATING DEFICITS

The statute provided that the excess-profits tax should be imposed only on that part of the net income remaining after deducting from net income the amount of a return at a rate fixed by the statute on what is described as "invested capital." It also provided that the "invested capital" should include

"surplus and undivided profits," and the problem here is to determine the meaning of the words "surplus and undivided profits."

According to their ordinary meaning it is plain that a corporation whose assets are less than its liabilities (including capital stock liability) has no surplus or undivided profits, and that a corporation which has had net earnings for two or three years, nevertheless has no surplus or undivided profits if, as the result of operating losses in the past, its capital has been, and still is, impaired. In this respect, there is no difference between "surplus" and "undivided profits." These terms are different labels for the same thing.

It is common practice for corporations, especially banking and financial corporations, to divide their true surplus funds into two items on their books, one called "surplus" and the other "undivided profits." When this is done it is generally understood that the "surplus," although representing assets in excess of liabilities and therefore divisible as dividends, is set apart as a more or less permanent addition to the working capital, while "undivided profits," usually representing recent net earnings, are usually understood to be intended for immediate distribution as dividends or, possibly, to be transferred to the so-called surplus account. In any event "surplus" and "undivided profits" are alike in one respect, in that each represents a part of the amount by which the assets exceed the liabil-

ities (including capital-stock liability), and in that neither surplus nor undivided profits exist if the assets do not exceed the corporation's liabilities (including capital-stock liability).

For a corporate financial statement to attempt to set up either a surplus or an undivided profits account, when its capital is impaired, would be absurd. The term "undivided profits" carries the inference that the profits are divisible as dividends and has never been used in any other sense. Every one with the most elementary knowledge of accounting knows these things to be so.

See—

Leather Manufacturers' National Bank v. *Treat,* 116 Fed. 774.

Insurance Company of North America v. *McCoach,* 218 Fed. 905, 908.

The respondent, Milton Dairy Company, between the date of its organization and February 28, 1917, the beginning of its fiscal year 1918, had suffered losses in operation, resulting in an impairment of its capital in the amount of $70,296.12. Its net earnings for its fiscal years 1918 and 1919 aggregated only $34,397.40. The impairment of capital was not made good.

It is plain that the net earnings of 1918 and 1919 produced neither "surplus" nor "undivided profits," as those terms are ordinarily understood. Unless, therefore, there is some reason for assigning to these words as used in this statute a meaning out of the ordinary, the Commissioner was clearly

right in holding that there were no undivided profits to form an addition to the statutory invested capital.

We are unable to find anything in the terms of the statute or in its purpose which justifies the rejection of the ordinary meaning of these terms.

The underlying principle of the "excess" profits tax was that the taxpayer should be allowed, free of the tax, a reasonable return fixed by the statute on his investment and what had been added to it by accumulation of profits. See *LaBelle Iron Works* v. *United States,* 256 U. S. 377. From the total net income there was to be deducted the amount prescribed by the statute as a reasonable return on what the statute defines as "invested capital" and the remainder of the income was treated as "excess" profits and subjected to the excess profits tax. The "invested capital" so prescribed was not the actual capital in the business during the tax year in question. The statute prescribed what items of the amounts originally invested in the corporation's shares should be included in the invested capital, and provided in subdivision (3) here in question that "paid-in or earned surplus and undivided profits" should be included. Two kinds of surplus were included, that "paid in" and that "earned." The provision in subdivision (3) relating to "paid-in" surplus was probably unnecessary except to cover surplus "paid in" by the stockholders after shares were issued and not

in payment for shares (a most unusual case), because surplus paid in for shares was already included by subdivisions (1) and (2).

The statute and the regulations adopted the equitable view that the deduction from income of a reasonable return on the amounts contributed by the stockholders should be allowed notwithstanding the investment had been lost or impaired by losses in operation, but there was no equitable ground for, and there is nothing in the statute to require, allowing *earned* surplus and undivided profits, not contributed out of the pockets of the stockholders, to become a fixed and permanent part of "invested" capital, not reducible by subsequent operating losses, or, conversely, as claimed by respondent in this case, where the operating losses and impairment of capital occur first, allowing the later net earnings to become a fixed addition to "invested capital," although insufficient to restore the previous operating losses of the capital investment.

The reasoning of the Circuit Court of Appeals and the argument of the respondent both lead to the conclusion that all net earnings in any year became an addition to invested capital, but net losses in any year never operated to reduce such additions to invested capital, with the result that the invested capital might be increased but never reduced as the result of gains or losses in operation. See *Appeal of Gould Coupler Co.*, 5 B. T. A. 499, 517. Such a conception is artificial and arbi-

trary, has no basis in reason, and is not suggested by anything in the statute. There seems to be a difference in this respect between paid in surplus and earned surplus, recognized by Article 860 of the Regulations, and it is quite logical that there should be a difference between additions to invested capital resulting from investments by the stockholders and additions not contributed by them but resulting from operations.

The opinion of the Circuit Court of Appeals offers no satisfactory reason for failing to give to the words "surplus and undivided profits" their usual significance.

It discloses some confusion as to the operation of the statute in speaking of deducting invested capital from income (R. 25) and the "deduction of 'undivided profits' as part of the 'invested capital'" (R. 26), things which do not occur under the statute.

The extract in the opinion of the Circuit Court of Appeals from the opinion of this Court in *Edwards* v. *Douglas,* 269 U. S. 204, gives no support to the decision below. In that case this Court was dealing with the rate of taxation on dividends which depended on the year in which the profits out of which the dividends were paid were accumulated. Clearly, there could be no dividends in the absence of assets in excess of liabilities (including capital stock liability) and everything the Court held or said about earnings in that case related to earnings which had the effect of creating or increasing a sur-

plus or undivided profits properly divisible as dividends, and therefore representing an increase in the assets over and above the amount of liabilities.

The Circuit Court of Appeals rejects the usual formula for ascertaining surplus and undivided profits, which is to determine the amount of assets in excess of liabilities, but we have searched in vain in the opinion for any substitute or any definite statement of the method which is to be used. If the learned Circuit Judge who wrote the opinion had attempted to work out his theory in a concrete way he would have reached an impasse.

The respondent offers no more satisfactory reasoning or formula. The Circuit Court of Appeals treated "surplus" and "undivided profits" alike and held that there could be both surplus and undivided profits as the terms are used in this statute, notwithstanding the corporation's assets were less than its liabilities and its capital was impaired. It thus recognizes our contention that "surplus" and "undivided profits" are merely accounting terms to describe essentially the same thing. The respondent abandons the Circuit Court of Appeals in this. It concedes that there was no "surplus," but still contends that there were "undivided profits." In its brief in opposition to the petition for certiorari it is said (p. 4):

> This respondent has never claimed a surplus, does not now claim a surplus, and has not the hardihood to claim any rights by virtue of a "surplus."

This argument has the additional weakness that it yields the point that the word "surplus" was used in this statute in its ordinary sense and yet insists that the words "undivided profits" in the same sentence are to be given some artificial or unusual meaning. "Net earnings" for a particular period and "undivided profits" are different things, and yet respondent treats them as synonymous. If it used "net earnings" as describing the net earnings for the entire period of the corporation's existence *taken as a whole* we would not complain, because then the result would be "undivided profits" as we understand the term only if aggregate earnings for some years exceeded the aggregate losses in the others, but to say that undivided profits exist because in one or two years of a corporation's existence it has made net earnings which are less than its aggregate net losses during the other years of its existence, is to arbitrarily manufacture new meanings for well understood words.

If anything further need be said it is that the Treasury Department has consistently applied the law as we urge it, and its regulations have for years provided accordingly. The Board of Tax Appeals has sustained it (*Appeal of Valdosta Grocery Co.*, 2 B. T. A. 727), and followed the opinion of the District Court in this case. No adequate reasons are advanced for overturning the established practice of the Bureau of Internal Revenue and rejecting the construction of the

statute it has so long applied. The District Court was right and the judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted.

WILLIAM D. MITCHELL,
Solicitor General.
MABEL WALKER WILLEBRANDT,
Assistant Attorney General.
A. W. GREGG,
General Counsel, Bureau of Internal Revenue.
J. R. WHEELER,
Special Attorney, Bureau of Internal Revenue.

SEPTEMBER, 1927.

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1926.

No. [redacted] 156

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA,

Petitioner,

v.

MILTON DAIRY COMPANY,

Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

HAYDN S. COLE,
Attorney for Respondent.

INDEX.

	Page.
Question Presented	1
The Statute	2
Statement of the Facts	3
Argument	5
Conclusion	8

AUTHORITIES CITED.

Cases:

Edwards v. Douglas, 269 U. S. 204 5

Statutes:

Revenue Act of 1918, C. 18, Sec. 326 (a) (3) 40 Stat. 1057 2

Revenue Act of 1921, C. 136, Sec. 301, Sec. 1400, 42 Stat. 272, 320 2

Revenue Act of 1926, Sec. 284 2

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BRIEF FOR RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

QUESTION PRESENTED.

The question now before this court is, should a writ of certiorari issue to review the decision of the Court of Appeals because that decision involved an important question of Federal law which has not been but should be settled by this court; in other words, is this such a special or important case that this court should grant the petition?

THE STATUTE.

Revenue Act 1918, C. 18, 40 Stat. 1057, 1092.

Sec. 326 (a) That as used in this title the term "Invested Capital" for any year means * * *

* * * * * * *

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year.

Said Statute and all excess profits tax laws were repealed or expired by limitation December 31, 1921. Revenue Act 1921, Sec. 301 and Sec. 1400, C. 136, 42 Stat. 272, 320.

The last return for and payment of any excess profits taxes was due in 1922. The four-year limitation in Section 284, Revenue Act of 1926, has run as to all taxes paid in 1922, and for which no claim for refund has been made.

STATEMENT OF THE FACTS.

The statement of facts in petitioner's brief is correct, except the use of the word "alleged" applied to profits, to which respondent objects, as hereinafter set out.

The Court of Appeals decided that undivided profits constitute part of the invested capital (of Section 326 (a) (3), Revenue Act of 1918), upon which respondent was entitled to a credit and deduction, and that the Department's regulation requiring restoration of depleted capital was contrary to the law.

On page 7 of petitioner's brief is stated the "Specification of Error to be Urged" as follows:

> "The Court erred in holding that under Section 326 of the Revenue Act of 1918 the invested capital of a corporation can be increased by *alleged* earned *surplus or* undivided profits where there exists an operating deficit in excess thereof."

The italics are respondent's and point out the errors in petitioner's only proposed specification:

1st. *Alleged* means "asserted to be true but not proved." On page 23 of Transcript, among the stipulated facts, appear,

> "That the net income of the plaintiff for the fiscal year ending February 28th, 1918, amounted to $11,489.26" and
>
> "That the net income of the plaintiff for the fiscal year ending February 28th, 1919, amounted to $22,908.14,"

and on page 22 of the Transcript is the stipulated fact that "additional Income and Excess Profits Tax" against the plaintiff were assessed by the Commissioner for said

years 1918 and 1919 respectively on the aforesaid net income. It is part of this "additional" tax that was assessed and paid under protest that respondent brought its action to recover.

Are such profits which have been subjected to and paid an excess profits tax reaching to 80%, "alleged"?

2nd. There is not and never was any "surplus or" in this case, except as the Special Attorney has steadily persisted in ignoring "undivided profits" and emphasizing "surplus." This respondent has never claimed a surplus, does not now claim a surplus, and has not the hardihood to claim any rights by virtue of a "surplus". This respondent had "undivided profits," has paid heavy taxes on "undivided profits" and desires to recover "Additional Excess Profits Tax" which it was compelled to pay on these "undivided profits," because the Commissioner would not permit respondent to earn and keep eight per cent upon these "undivided profits" before imposition of the heavy excess profits tax.

ARGUMENT.

It is respectfully submitted that none of the reasons for granting the writ set out in the petitioner's brief justify the granting of the petition. Taking these in order:

1. The Circuit Court of Appeals did not misconstrue Section 326 (a) (3) of the Revenue Act of 1918. On the contrary, that Court's construction followed and applied this Court's definition of "undivided profits" in *Edwards v. Douglas,* 269 U. S. 204, and quoted at length from that decision (see p. 33 Transcript). Respondent will not attempt to burden this court with another version of reasons so clearly and emphatically given in the opinion of the Court of Appeals. It is submitted that that opinion (pp. 32, 33, 34, 35 Transcript) so convincingly sets forth the law of this case, that on the merits the writ should be denied.

2. The second reason fails in that no issue in this case involves the definition of surplus, as we have stated above. No claim is made that Milton Dairy Company had a surplus.

The respondent claims that the respondent's profits for the years 1918 and 1919, on which the respondent paid income tax, excess profits and war profits taxes, and which earnings remained in the business, are *undivided profits* within the meaning of Section 326 (a) (3).

The tax was assessed by the Commissioner of Internal Revenue, the case tried for the government in the District Court, argued in the Circuit Court of Appeals, and is now brought to this court, practically all action and argument

is based upon the absence of a surplus, and not, as the facts demand, upon the existence of "undivided profits."

3. There is nothing in petitioner's reason No. (3) (top p. 8 petitioner's brief) but a broad, indefinite statement that a proper construction of Sec. 326 is "fundamental in auditing many thousands of corporation returns, etc.," and "affects a large number of cases not finally closed." This may all be true. The statement might have been broader, more comprehensive, if it had said that a proper construction of the Revenue Act of 1918 is "fundamental in auditing, etc." Why limit it to Section 326? Section 326 is long, contains many provisions applying to invested capital, intending to, and did, affect a wide range of corporate circumstances and conditions, and even though inapplicable to any tax accruing after 1921, there are probably cases pending under some of the provisions of the section. But the only provision in which this case is interested is (a) (3). The only question in this case is, must depleted capital be restored before undistributed undivided profits are entitled to a deduction?

The Commissioner has information, and was in a position to state whether there are other cases pending to be affected by this case, and in the absence of a definite statement, the court is justified in disregarding a very general statement with reference to the long section 326.

Petitioner does not state that there is another case pending anywhere that will be affected by this case. This respondent is certain there are few, if any because:

(1) Respondent can find but one ruling of the department on the question here, Art. 838, Regulations 45, 1920 Edition, and can find no other ruling or interpretation, or record of any action or any case like

the one at bar. Certainly no great number could have escaped attention.

(2) Taxation of earnings of a corporation made since December 31, 1921, cannot be affected since the law was repealed or expired by limitation on that date, and the last excess profits tax was payable in 1922.

(3) The Statute of Limitations, Sec. 284, Revenue Act of 1926, applies to all taxes paid in 1922. The limitation is four years.

(4) More than five years have passed since any earnings were subject to excess profits tax.

4. The unimportance of petitioner's reason (4) is apparent from the answer above made to reason (3) and particularly because of the Statute of Limitations. There will be no more taxpayers' return under the repealed law, and the practice of the Department under its provisions is about at an end. Of the "long-established and accepted practice of the Treasury Department", a change of which is said to be threatened, it is difficult to speak without sarcasm. Veneration for the practice of the Department ceases when one thinks of the hundreds of millions of dollars that this court has compelled that Department to refund. The regulations and practice of that Department, fortunately for the taxpayer, are not authority here.

5. There is nothing persuasive in reason (5).

The Board of Tax Appeals has filed over two thousand decisions. Petitioner cites three out of this vast number in support of the argument that the decision of the Circuit Court of Appeals is "contrary to the uniform decisions of the U. S. Board of Tax Appeals."

Long Beach Development Co. v. Commissioner and *Gould Coupler Co. v. Commissioner* (neither yet reported) are not at all in point.

It is surprising that petitioner cites Appeal of *Valdosta Grocery Co.*, 2 B. T. A. 727. That decision cites, and seems to have been decided largely on authority of, the decision of the District Court against respondent in the present case, which decision was reversed by the Circuit Court of Appeals. That the Board of Tax Appeals in two and one-half years of its existence has decided but a single appeal, even remotely resembling the present case, is evidence of the strongest kind that the decision of the Circuit Court of Appeals has such a restricted application that the writ should be denied.

CONCLUSION.

This case involves the sum of $1,804.19.

It was correctly decided in the Court of Appeals.

The law under which it arose was a war measure repealed or expired December 31, 1921.

The Statute of Limitations has run on all taxes paid in 1922.

There are no special or important reasons why this court should review the decision below.

It is asked that the petition for a Writ of Certiorari be denied.

Respectfully submitted,

HAYDN S. COLE,
Attorney for Respondent.

FILED
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SUPREME COURT OF THE UNITED STATES

October Term, 1927.

No. 156.

L. M. Willcuts, Collector of Internal Revenue for the District of Minnesota, Petitioner.

vs.

Milton Dairy Company.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

BRIEF ON BEHALF OF RESPONDENT.

HAYDN S. COLE,
Attorney for Respondent.

INDEX.

	Page.
The question	1
The statute	2
Statement	2
Summary of Argument	3
Argument:	
Undivided profits having been determined as of annual accounting periods, the profits so ascertained having been taxed under the Revenue Act, and left undistributed in the business, there being no subsequent operating deficit, are undivided profits under Sec. 326 (a) 3, and need not be applied in reduction of an operating deficit incurred prior to the enactment of the excess profits tax law	4

CITATIONS.

Cases:	
Edwards v. Douglas, 269 U. S. 204	4
Gould Coupler Co., Appeal of, 5 B. T. A. 499	5
Gould v. Gould, 245 U. S. 151	8
Insurance Company of North America v. McCoach, 218 Fed. 905	5
LaBelle Iron Works v. United States, 256 U. S. 377	8
Leather Manufacturers' National Bank v. Treat, 116 Fed. 774	5
Valdosta Grocery Co., Appeal of, 2 B. T. A. 727	5
Statutes:	
Revenue Act of 1918, c. 18, Sec. 326 (a)	2
Revenue Act of 1918, c. 18, Sec. 212 (b)	6

SUPREME COURT OF THE UNITED STATES

October Term, 1927.

No. 156.

L. M. WILLCUTS, COLLECTOR OF INTERNAL REVENUE for the District of Minnesota, Petitioner.

vs.

MILTON DAIRY COMPANY.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

BRIEF ON BEHALF OF RESPONDENT.

THE QUESTION.

The question in this case is: Must the deficit incurred prior to the enactment of the Excess Profits law be replaced before the net earnings for years subsequent to the enactment of the law can be added to the invested capital?

THE STATUTE.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1092.

Sec. 326. (a) (so far as relevant to the question in this case, provided):

> That as used in this title the term "invested capital" for any years means * * *
>
> (1) Actual cash bona fide paid in for stock or shares.
>
> (2) Actual cash value of tangible property other than cash, bona fide paid in for stock or shares * * *.
>
> (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year.

STATEMENT.

Prior to the enactment of the excess profits tax law, respondent suffered operating losses impairing its capital, $70,296.12. Pursuant to that law the Commissioner of Internal Revenue, as of February 28, 1917, fixed the amount of respondent's invested capital as $145,817.04, this being the cost of the original investment, and thus the amount upon which respondent was entitled to earn 8% before the extraordinary excess profits and war profits taxes applied. During each of the three years immediately following the enactment of the excess profits tax law, respondent operated at a profit. These net earnings were not paid out in dividends, but were left in the business undivided.

There was no operating loss in any of these years.

SUMMARY OF ARGUMENT.

Invested capital is a creation of the Revenue Act to exempt certain income from excess profits and war profits taxes, to relieve the taxpayer of part of the burden of these extraordinary taxes, and the Act gives the respondent a right to add to the invested capital certain earnings left undistributed in the respondent's business.

There is nothing in the Revenue Act requiring such earnings to be applied in reduction of an operating deficit incurred prior to the enactment of the excess profits tax law.

Undivided profits having been determined as of annual accounting periods, the profits so ascertained taxed under the Revenue Act, and left undistributed in the business, there being no subsequent operating deficit, are undivided profits under Sec. 326 (a) (3).

The Treasury Department cannot, by construction or regulation, impose a tax burden not imposed by the Revenue Act itself.

ARGUMENT.

The question involved in this case is met and answered in the opinion of the Circuit Court of Appeals and we will not burden this Court with another version of reasons so clearly and emphatically given in that opinion.

The Circuit Court of Appeals correctly decided the case.

The Government prevailed in *Edwards v. Douglas*, 269 U. S. 204, the Government's contention there being, as stated by the Court:

> "The Government contends that the phrase "most recently accumulated *undivided profits* or surplus" in section 31 (b) *includes current earnings of the year* in which the dividends are paid; and that, as the earnings of 1917 were ample to pay these dividends, the 1917 dividends are conclusively presumed to have been paid out of 1917 earnings." (Italics ours.)

This Court will not permit the Government to "blow hot and blow cold" in its definition of undivided profits, that it may impose a tax by one definition and by another definition deprive a taxpayer of the slight relief from excess profits and war profits taxes expressly granted by the statute.

This respondent contends that the words "undivided profits" in Section 326 (a) (3) expressly make annual earnings of respondent, on which the taxes imposed by the Act have been paid, a part of respondent's invested capital.

There is nothing in the petitioner's brief to take away from or in any way modify the definition of undivided profits in *Edwards v. Douglas*, supra, quoted in the Circuit Court of Appeals decision.

The lack of any real authority to support petitioner's argument is shown by the cases cited in its support.

Two are decisions of the Board of Tax Appeals:

Appeal of Valdosta Grocery Co., 2 B. T. A. 727, seems to have been decided on authority of the decision of the District Court in the present case, which decision is now before this court.

Appeal of Gould Coupler Co., 5 B. T. A. 499. This case is not at all in point applying as it must only where several corporations are affiliated and treated as a unit for income and excess profits tax purposes.

Decisions of U. S. District Court and Circuit Court of Appeals, respectively, cited by petitioner:

Insurance Company of North America v. McCoach, 218 Fed. 905,

Leather Manufacturers' National Bank v. Treat, 116 Fed. 774,

are not in point, as neither case requires or has any definition of undivided profits.

Nowhere in petitioner's argument is there anything to show what the money, $11,489.26 and $22,908.14, earned in the fiscal years ending in 1918 and 1919 is if it is not undivided profits, and all of the academic discussion of bookkeeping terms cannot take away the solid fact—unaffected by bookkeeping terms—that over $34,000 was earned by respondent, taxed by the government, and left in the respondent's business.

All the argument in petitioner's brief cannot take this fact out of the case, nor change the fact that this money so earned and left in the business is exactly what Congress

intended to be a measure for some relief to the taxpayer when it provided in Section 326 (a) (3) that "undivided profits" are to be added to invested capital.

Undivided profits must be determined as of annual accounting periods.

The Revenue Act of 1918 required the Dairy Company to ascertain its net income in each fiscal year.

Sec. 212 (b):

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer * * *."

The law makes each year a unit within which is determined whether or not there is taxable income. The Dairy Company has so ascertained its net income for each of the years in question, and it follows as a matter of course that net income on which it has paid income and excess profits tax and which income remained in the business is undivided profits.

No better digest of the decision of the Circuit Court of Appeals in our case and of the respondent's contention can be made than the statement in petitioner's brief (p. 11):

> "The underlying principle of the "excess" profits tax was that the taxpayer should be allowed, free of the tax, a reasonable return fixed by the statute on his investment *and what had been added to it by accumulations of profits.* See LaBelle Iron Works v. United States, 256 U. S. 377." (Italics ours.)

With such a clear understanding of the purpose and effect of Section 326 (a), the Commissioner is acting in

an arbitrary and illegal manner in refusing to add to respondent's original investment $34,397.40, being profits earned after the enactment of the law, which profits have been subjected to the income, excess profits and war profits taxes imposed by the same law.

Petitioner's argument is devoted to a discussion of bookkeeping terms.

The act does not make mere bookkeeping entries the test of invested capital.

Congress wholly ignored these in creating invested capital in Sec. 326 (a).

The law looks to the substance—the cost of original investment—the amount of money later paid in—the money earned and left in the business.

If on the enactment of the law, respondent's articles of incorporation had been amended—a simple and inexpensive proceeding—and respondent's capital thereby reduced by cancellation of $75,000 of its stock, the resulting book entries and balance sheet would have eliminated the deficit of $70,296.12 and instead there would have appeared a surplus of almost $5,000. The balance sheet would show "excess of assets over liabilities (including capital stock") and so meet the test in petitioner's brief (pp. 7, 8, 9, 10, 14).

If the capital had been so reduced, the Commissioner would still fix the invested capital at $145,817.04, as that was the cost of the original investment.

If the stockholders had paid $34,397.40 in cash into the company after the capital had been so reduced, that amount would certainly have been added to the invested capital.

When respondent earned $34,397.40 in cash and left it undivided, would petitioner claim this sum must be applied to make up the amount by which the capital had been reduced by amendment of the articles and cancellation of stock?

That the Commissioner is wrong in his insistence that the balance sheet is controlling, and not the fact of the amount of money invested and earned and left in the business, is decided in *LaBelle Iron Works v. United States*, 256 U. S. 377, where stock issued to evidence an actual appreciation in value of almost Ten Million Dollars was held not to be a factor in determining invested capital.

Respondent has asked the Courts to reverse the Commissioner's ruling and the regulation of the Treasury Department, and now claims that petitioner should not urge the Department's practice as ground for reversal of the Circuit Court of Appeals.

Nothing in petitioner's brief attempts to justify the Commissioner except that Regulation 45 (1920 Edition) Article 838 is cited.

This regulation is merely a Departmental interpretation of the law and is not sufficient authority to take away from respondent a right given by the law itself. There is nothing in the Revenue Act requiring earnings to be applied against respondent's operating deficit.

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen."
>
> *Gould v. Gould*, 245 U. S. 151.

Section 326 (a) (3) is in clear, positive and unambiguous language, and the law there includes as part of "invested capital":

> "3. Paid-in or earned surplus and *undivided profits;* not including surplus and undivided profits earned during the year."

Did Congress say to all corporations whose capital was impaired at the time the law took effect:

> "You will not be allowed to have the 8% excess profits credit on your earnings left undistributed until your impaired capital has been made good?"

We do not believe it was intended to so penalize the corporation which, with the handicap of impaired capital, earned profits yielding income, excess profits and war profits taxes to the government.

Respondent was not relieved from taxation on its earnings (left undistributed) until its impaired capital was restored, but the Act required it to report these earnings at the end of each year as *profits* and pay taxes thereon at the highest rate known in this country's history.

The tax is imposed upon net income and profits of each taxable year; invested capital is the cost of the original investment plus subsequent additions. Previous operating loss is not a factor to be considered in ascertaining taxable *profits*, nor can it be a factor in fixing the amount of invested capital.

The "clear import" of the statute which levies an excess profits tax on this $34,297.40 does not require impaired capital to be replaced before allowing in following years the reasonable return of 8% upon the identical amount upon which income and excess profits taxes were levied and collected.

For the reasons stated, it is therefore most respectfully submitted that the judgment of the Circuit Court of Appeals is correct and should be affirmed.

HAYDN S. COLE,
Attorney for Respondent.

SUPREME COURT OF THE UNITED STATES.

No. 156.—October Term, 1927.

L. M. Willcuts, Collector of Internal Revenue for the District of Minnesota, Petitioner,
vs.
Milton Dairy Company.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[November 21, 1927.]

Mr. Justice Sanford delivered the opinion of the Court.

The Dairy Company, a Minnesota corporation, brought this suit against the Collector to recover additional excess-profits taxes assessed against it under Title III of the Revenue Act of 1918[1] for its taxable years 1919 and 1920,[2] and paid under protest. Judgment for the Collector in the District Court, 8 F. (2d) 178, was reversed by the Circuit Court of Appeals. 15 F. (2d) 814.

The question here is whether profits earned by the Company that were insufficient to offset an impairment of its paid-in capital, were "undivided profits" to be included as "invested capital" in computing the excess-profits credits allowed by the Act.

Sec. 312 of the Act provided that the "excess-profits credit" of a domestic corporation should "consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year." Sec. 326 (a) defined the term "invested capital", with certain exceptions not now material, as the actual cash and cash value of other property bona fide paid in for stock or shares, at the time of such payment, and "(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year." Art. 838 of

[1] 40 Stat. 1057, 1088, c. 18.

[2] These were the fiscal years of the Company ending on the last day of February in 1919 and 1920, respectively. They are designated, in accordance with §§ 200 and 300 of the Act, by the years in which they ended.

Treasury Regulations 45[3] declared that: "Only true earned surplus and undivided profits can be included in the computation of invested capital. . . . In the computation . . . full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year. . . . There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses or any other cause has been made good."

The Company was organized with a paid-in capital of $145,817.04. At the end of 1917[4] an operating deficit of $70,296.12, shown on the books, impaired the capital to that extent. In 1918 the Company had a net income of $11,489.26; and in 1919 a net income of $22,908.14. These earned profits were not distributed, and $29,853.03 thereof remained in the business at the end of 1919, without having been applied to reduce the impairment of the capital.

In the returns on which the excess-profits taxes were originally assessed and paid, the Company, treating these earnings as "undivided profits" constituting part of its "invested capital," reported as invested capital for 1919 the sum of the paid-in capital, $145,817.04, and the profits, $11,489.26, earned in 1918; and as invested capital for 1920 the sum of the paid-in capital and the $29,853.03 of profits earned in 1918 and 1919 and remaining in the business.

Thereafter, on an audit of the returns, the Commissioner of Internal Revenue, while allowing for each year as "invested capital" the amount of the paid-in capital, excluded from the computation of the "invested capital" the amounts claimed as "undivided profits," on the ground that they did not constitute true "undivided profits" but should be applied to reduce the impairment of the capital. And on the basis of such exclusions he assessed the additional taxes.

We think that clause (3) relating to "surplus and undivided profits" was correctly interpreted by Art. 838 of the Treasury Regulations. Both these terms as commonly employed in corporate accounting denote an excess in the aggregate value of all the assets

[3]Regulations 45 (1920 Ed.), p. 204.

[4]The references in this opinion are to the taxable years, designated as stated in note 2, *supra*.

of a corporation over the sum of all its liabilities, including capital stock. See *Edwards* v. *Douglas*, 269 U. S. 204, 214; *Insurance Co. of North America* v. *McCoach* (D. C.), 218 Fed. 905, 908. Aside from the fact that a surplus may not only be "earned," as where it is derived from undistributed profits, but "paid-in," as where the stock is issued at a price above par, the distinction between these terms, as commonly employed, is that the term "surplus" describes such part of the excess in the value of the corporate assets as is treated by the corporation as part of its permanent capital, usually carried on the books in a separate "surplus account;" while the term "undivided profits" designates such part of the excess as consists of profits "which have neither been distributed as dividends nor carried to surplus account." *Edwards* v. *Douglas*, *supra*, 214. But it is a prerequisite to the existence of "undivided profits" as well as a "surplus," that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute "undivided profits."

We cannot doubt that this term was used in clause (3) with its ordinary meaning, nor agree with the view of the Circuit Court of Appeals that the arbitrary definition given by the Act to the term "invested capital" not equivalent to that of the ordinary invested capital of commerce, indicates that the words "surplus and undivided profits" were not used with their ordinary meaning as conditioned by an excess of assets. We do not think Congress intended that a corporation whose capital was impaired should be entitled to treat profits that, though earned, were insufficient to make good the impairment and create a surplus, as "undivided profits." This would not only give the term "undivided profits" a meaning entirely at variance with ordinary usage—making it merely equivalent to any earned profits remaining in the business—but would grant the privilege of twice disregarding the impairment of capital, that is, once in computing the paid-in capital, which under the express terms of the Act was to be taken at the full cash or money value at the time of payment, and again in computing the "undivided profits." This term is entirely inapt to express such a purpose.

This conclusion is in harmony with the general view expressed in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, 388. Dealing

there in another aspect with the Revenue Act of 1917, which contained a similar clause concerning the inclusion of "paid-in or earned surplus and undivided profits as "invested capital" in determining the amount of the excess-profits tax, this Court said, *arguendo*, that in order to avoid exaggerated valuation of invested capital "the act resorted to the test of including nothing but money, or money's worth, actually contributed or converted in exchange for shares of the capital stock, or actually acquired through the business activities of the corporation . . . and coming in *ab extra*, by way of increase over the original capital stock," and that the provision including "paid in or earned surplus and undivided profits used or employed in the business" recognized "that in some cases contributions are received from stockholders in money or its equivalent for the specific purpose of creating an actual excess capital over and above the par value of the stock." And see *Appeal of Valdosta Grocery Co.*, 2 B. T. A. 727, 729, and *Appeal of Gould Copper Co.*, 5 B. T. A. 499, 517.

The fact that under Title II of the Revenue Act of 1918 providing for an income tax, a corporation, as was held in *Long Beach Improvement Co.* v. *Commissioner of Internal Revenue*, 5 B. T. A. 590, was subject to a tax upon its net income despite an impairment of its capital, is not of moment. The deductions from gross income allowed by that Title do not refer to invested capital, surplus or undivided profits, and its provisions throw no light upon the meaning of those terms as used in Title III providing for an excess-profits tax.

The judgment of the District Court is affirmed; and that of the Circuit Court of Appeals

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.